75% of eligible young people are missing out on a smart way to save for retirement: Accountant

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Employers are increasingly offering a valuable retirement-saving tool to workers. In addition to traditional 401(k) plans, about 8 in 10 workplaces now let workers invest in a Roth 401(k), up from just 37% that offered the option in 2010, according to a recent survey from investing research firm Callan.

Workers aren't exactly beating down the doors to take them up on it. Only about a quarter of 401(k) investors opt to contribute to a Roth plan — a number that has remained fairly steady over the years, according to the American Retirement Association.

If your workplace is among those that offer a Roth, ignoring it could mean giving up on a powerful tool for building long-term wealth, says Ed Slott, a certified public accountant and publisher of IRAHelp.com. "Anything that can help you build wealth tax-free in this tax environment we're in is a good move," he says. And although there are no guarantees concerning what you'll pay in taxes down the line, he says, for many younger investors who can opt in, "the Roth 401(k) is a slam dunk."

How Roth 401(k) retirement accounts work

Traditional 401(k)s come with an upfront tax advantage that you won't get with a Roth 401(k). Contributions to traditional plans are made with pretax money and count against your taxable income for the year that they're made. That means if you earn $89,000 and make a $19,000 contribution to your traditional 401(k), you're taxed on $70,000 worth of income. In exchange for this upfront benefit, you'll owe taxes on the entire amount of your portfolio when you withdraw the money in retirement.

Roth 401(k)s turn this dynamic on its head. You fund these accounts with money you've already paid taxes on, and your investments within them grow tax-free. Provided you're 59½ and have held the account for at least five years, you can withdraw your contributions and earnings without owing another dime to the federal government.

Roth 401(k)s versus Roth IRAs

If you think those rules sound awfully familiar, you're right: They're the same ones that apply to Roth IRAs. But the Roth 401(k) bears a few distinct differences. Unlike Roth IRAs, the accounts offered through your workplace don't come with an income limit, so you can contribute regardless of your salary. And you can contribute quite a bit more. For 2021, you can contribute up to $19,500 to a 401(k), Roth or traditional, with an additional $6,500 "catch-up" contribution if you're age 50 or older. The maximum contribution to a Roth this year is $6,000, plus another $1,000 for the 50 and up crowd.

Because they're offered by your workplace, Roth 401(k)s do come with some stipulations that you won't encounter with an IRA. For one, unless you're still an employee and don't own at least 5% of the sponsoring company, you must begin taking distributions from your Roth 401(k) account once you reach the age of 72 or face a penalty from the IRS. "That's easy enough to get around, though," says Slott. "As long as you get out of the plan, say, by rolling it into a Roth IRA before you're 72, you'll be fine."

Roth 401(k)s are less flexible than Roth IRAs. While you can withdraw your contributions at any time from a Roth IRA without tax or penalty, early withdrawals from Roth 401(k)s come with a 10% penalty.

Why it could be wise to consider a Roth 401(k)

Many investors favor the traditional 401(k) because it offers a form of immediate gratification, says James Regan, a financial advisor at SharpePoint in Phoenix, Arizona. "The IRS has hung this carrot out there. They're giving you a deduction on the seed so they can tax the crop later," he says. "And people think, 'I want my deduction today.' It's very attractive."

But forgoing the tax break today can net you huge gains down the road, depending on your financial situation, says Slott. "The whole decision is a bet on today's tax rates versus future tax rates," he says. "And the odds are heavily in your favor if you choose a Roth."

The reasoning behind the choice, Slott says, comes down to when you'll pay taxes on your investments. Because Roth money is taxed up front, you're theoretically coming out ahead if you expect to pay lower taxes now than you will at the time of your retirement. That may be the case for two reasons. One is advancement in your career. "For the most part, younger people are starting their careers in the lower tax brackets, and those upfront deductions aren't worth as much," he says. "If you take the tax deduction now, you end up paying for it much later in life when the rate you pay could be much higher."

Even if you don't ascend tax brackets over the course of your career, the government could still potentially hike tax rates. "Historically speaking, these are the lowest rates many people will see in their lifetime. From 1946 through 1964, when the boomers were born, the top federal rate exceeded 90% in every year but one," Slott says. "People always complain about taxes, but these are the good old days."

There are investors for whom electing a traditional 401(k) over a Roth makes sense, such as high earners who expect to fall into a lower tax bracket in retirement. And for some investors, it may make sense to stick with a traditional plan and convert their account to a Roth account via a one-time taxable event in retirement (though the long-term availability of this strategy is currently up for debate in Congress).

Still, investing at least some of your retirement savings in a Roth account is a potentially valuable move for many younger people, says Slott. "Even if mathematically you should invest in a traditional 401(k), in doing so, you're still growing a tax debt for later, and who wants to pay taxes in retirement?" he says. "And if you go with a Roth and 'lose,' your consolation prize is that you have locked-in a zero-percent tax rate on your retirement savings. That's the worst-case scenario."